[JOINT COMMITTEE PRINT]

TAX TREATMENT OF INTEREST PAID TO FOREIGN INVESTORS
(Including H.R. 3025 and H.R. 4029)

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON MAY 1, 1984

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet describes H.R. 3025 and H.R. 4029 which would repeal the withholding tax on certain interest paid to foreign investors. The Committee on Ways and Means has scheduled a hearing on this subject on May 1, 1984. The pamphlet also describes two provisions contained in both the House-passed Tax Reform Act of 1984 (H.R. 4170) and the Senate-approved Deficit Reduction Act of 1984 (Senate amendment to H.R. 2163), which would affect the tax treatment of international finance subsidiaries, and a provision of the Senate amendment which would phase-out the 30-percent withholding tax on interest over four years.

The first part of this pamphlet provides a discussion of present law. The second part contains background information relating to the taxation of interest paid to foreign investors. The third part describes the legislative proposals, including a summary of prior Congressional consideration. The fourth part compares the legislative proposals and discusses related policy issues. The fifth part of the pamphlet discusses revenue effects of these proposals.

I. PRESENT LAW

Overview

The United States taxes the income of U.S. citizens, residents, or corporations whether that income is from the United States or abroad. A credit is allowed for foreign income tax paid, up to the U.S. tax on foreign source income. Nonresident aliens and foreign corporations, however, are generally taxed only on income which is from U.S. sources.

Withholding tax on foreign investors

Where U.S. source income received by a nonresident alien or foreign corporation is interest, dividends, or other similar types of investment income, the United States imposes a flat 30-percent tax on the gross amount paid (subject to reduction in rate or exemption by U.S. tax treaties, as described below) if such income or gain is not effectively connected with the conduct of a trade or business within the United States (Code secs. 871(a) and 881). This tax is generally collected by means of withholding by the person making the payment to the foreign recipient of the income (secs. 1441 and 1442) and, accordingly, is referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final U.S. tax liability of the foreign recipient and thus the foreign recipient files no U.S. tax return with respect to this income.

If the interest, dividend, or other similar income is effectively connected with a U.S. trade or business of the foreign investor, that income is not subject to the flat 30-percent withholding tax on gross income, but instead is included in the U.S. income tax return which must be filed for the business and is taxed at the ordinary graduated rates.

Exemptions from the withholding tax

The tax law exempts certain interest and dividends from the 30-percent withholding tax. Interest from deposits in banks and similar institutions is exempt (secs. 861(a)(1)(A) and 861(c)). Original issue discount on obligations maturing in six months or less is exempt (secs. 871(a)(1)(A) and (C) and 881(a)(1) and (3)). Any interest and dividends paid by a domestic corporation which earns less than 20 percent of its gross income from sources within the United States (an "80/20 company") is also exempt from the 30-percent tax (secs. 861(a)(1)(B) and 861(a)(2)(A)). Also, interest on certain debt obligations which were part of an issue with respect to which an election had been made for purposes of the expired Interest Equalization Tax is exempt (secs. 861(a)(1)(G) and 4912(c)).

Interest paid on bank deposits within the United States, and the income of foreign governments from investments in the United States in bonds, stocks and other securities, is generally exempt

from U.S. tax (sec. 892). Treasury regulations deny the exemption for income which a foreign government receives from commercial activities in the United States or income which inures to the benefit of any private person. Although interest received by a foreign government might not qualify for the statutory exemption for foreign governments, that interest might be eligible for other exemptions (such as that available for interest on bank accounts).

There is no estate tax liability with respect to interest that would not be subject to the withholding tax if the decedent received it at the time of his death (secs. 2104 and 2105). In addition, individuals who are neither citizens nor domiciliaries of the United States are not subject to estate tax liability with respect to stock or debt obligations of a foreign corporation. Thus there is no estate tax liability in the case of an obligation of a U.S. corporation's foreign finance subsidiary, or in the case of a foreign corporation established to hold U.S. assets.

Tax treaty exemptions

In addition to the statutory exemptions listed above, various income tax treaties signed by the United States provide for either an exemption or a reduced rate of tax for U.S. source interest paid to foreign persons. The exemption or reduced rate applies only if the income is not effectively connected with a trade or business conducted in the United States through a permanent establishment or fixed base located in the United States.

It is generally the negotiating position of the United States, as expressed in Article 16 of the Treasury's model income tax treaty, to exempt interest from tax unless the income is effectively connected with a permanent establishment or fixed base. The treaty exemption is based on the assumption that the interest income will be taxed in the recipient's country of residence.

The withholding tax is generally reduced to zero under treaties with Austria, Denmark, Finland, West Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, the Netherlands, the Netherlands Antilles, Norway, Poland, Sweden, the U.S.S.R., and the United Kingdom. Reciprocal reductions in rate are provided under treaties with Belgium, Canada, Egypt, Morocco, and the Philippines (15 percent), Jamaica and Malta (12.5 percent), Korea (12 percent), France, Japan, and Romania (10 percent), and Switzerland (5 percent). Under some treaties, only certain interest (such as bank interest or interest on public debt) is exempt.

Treaty shopping

Although the treaty exemptions are intended to benefit only residents of the treaty country, it has been possible, as a practical matter, for investors from other countries to obtain treaty benefits. This is accomplished by establishing a subsidiary, trust, or other investing entity in a treaty country that borrows from a non-treaty country resident and re-lends the proceeds to a U.S. person. The conduit entity claims the treaty exemption for the interest it receives from the U.S. borrower. This use of U.S. tax treaties by third country investors to avoid any tax on the interest income, rather than to avoid a potential double tax, is referred to as "treaty shopping." The current U.S. treaty with the Netherlands Antilles has

been used extensively for this purpose by U.S. companies seeking to borrow in the Eurobond market free of the 30-percent withholding tax.

In 1981, Treasury withdrew a proposed treaty with the British Virgin Islands that would have allowed, like the U.S.-BVI treaty then in force, use by third country investors. Subsequently, the United States terminated the the BVI treaty after the Treasury Department found potential for abuse.[1]

In June 1983, the United States terminated the income tax treaties with Anguilla, Barbados, Belize, Burundi, Dominica, Falkland Islands, Gambia, Grenada, Malawi, Montserrat, Rwanda, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines, Seychelles, Sierra Leone, Zaire, and Zambia. Third country residents had the potential to use many of these treaties.

Compliance with tax liability on interest income

U.S. payors are generally required to file information returns to report the payment of interest (including original issue discount) of $10 or more. Nominees are generally required to file reports with respect to interest received and passed along to the beneficial owners. One copy of the return is required to be sent to the recipient of the interest and another copy is sent to the Internal Revenue Service.

Returns are generally required for amounts paid on corporate indebtedness. However, no information reporting is required in the case of interest paid to (or original issue discount accruing to) foreign investors if withholding tax is imposed on the payment or if withholding tax would be imposed but for a statutory or a treaty exemption. Back-up withholding does not generally apply to interest on which information reporting is not required.

The Code generally disallows an interest deduction (and a reduction in earnings and profits) to the issuer of corporate debt that is in bearer form. However, an exception is provided if the bearer bonds are issued under arrangements reasonably designed to insure that they are sold only to persons who are not United States persons, and the interest on the obligations is payable only outside the United States and its possessions. In addition, a statement must appear on the face of the obligation to indicate that any U.S. person who holds the obligation will be subject to limitations under U.S. income tax laws. These rules were enacted in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").

In order to secure a treaty exemption or reduction from U.S. withholding tax on U.S. source interest income, a foreign resident must file (or the resident's trustee or agent receiving the interest income must file on his behalf) IRS Form 1001 (Ownership, Exemption, or Reduced Rate Certificate). Form 1001 requires the disclosure of the identity and address of the owner of the bond. In the case of a bearer bond, the form must be presented to the payor by or on behalf of the foreign owner with each coupon. TEFRA requires that Treasury establish procedures for insuring that treaty

[1] A discussion of treaty shopping involving that treaty appears in Vogel, et al., "Inward Investments in Securities and Direct Operations Through the British Virgin Islands: How Serious a Rival to the Netherlands Antilles Island Paradise?" 34 Tax L. Rev. 321, 360 (1979).

benefits are available only to persons entitled to them. The Treasury could, for example, require recipients to certify their residence or to claim refunds for tax automatically withheld.

Even where the foreign investor presenting an interest coupon on a corporate bond is not entitled to a treaty rate reduction or exemption, the foreign investor is nevertheless required to present, with each such coupon, a certificate of ownership on Form 1001. Where the owner of the bond is unknown to the person presenting the coupons for payment, the regulations further provide that the first bank to which the coupons are presented for payment is to require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee (Treas. Reg. sec. 1.1461-1).

II. BACKGROUND

Eurobond market

The Eurobond market is not an organized exchange, but rather a network of underwriters and financial institutions who market bonds issued by private corporations (including finance subsidiaries of U.S. companies), foreign governments and agencies thereof, and other borrowers.

In addition to individuals, purchasers of the bonds include institutions such as banks (frequently purchasing on behalf of investors with custodial accounts managed by the bank), investment companies, insurance companies, and pension funds. There is a liquid and well-capitalized secondary market for the bonds with rules of fair practice enforced by the Association of International Bond Dealers. Although a majority of the bond issues in the Eurobond market are denominated in dollars (whether or not the issuer is a U.S. corporation), Eurobonds are also frequently denominated in other currencies (even when issued by U.S. multinationals).

In general, an issuer of Eurobonds pays interest, premiums, and principal net of any tax which might be withheld at source (subject to a right of the issuer to call the obligations in the event that a withholding tax is imposed as a result of a change in law or interpretation occurring after the obligations are issued). Some U.S. corporations borrow from the Eurobond market free of the U.S. withholding tax by issuing bonds through foreign finance subsidiaries, almost all of which are incorporated in the Netherlands Antilles. U.S. companies do not currently issue bonds directly in the Eurobond market due to the 30-percent withholding tax.

Foreign borrowers avoid withholding tax imposed by their home jurisdiction either through extraterritorial finance subsidiaries (e.g., certain German financings) or through specific statutory exemptions. In some cases, statutory exemptions apply to interest paid to foreign investors generally (e.g., in the Netherlands and Sweden) or, more frequently, the exception is contingent on the bond being issued in a foreign currency (e.g., Japan). Few foreign governments exempt all interest paid to nonresidents from withholding tax.

Unlike bonds issued in the U.S. capital market, Eurobonds are issued in bearer (rather than registered) form. Thus, the anonymity of the holder of the bond is protected—the holder's identity is not disclosed to the issuer, the United States, or the government where the holder resides.

International finance subsidiaries

When U.S. corporations borrow abroad, they generally do so through the use of foreign finance subsidiaries. Finance subsidiaries are usually paper corporations, without employees or fixed

assets, which are organized to make one or more offerings in the Eurobond market, and the proceeds of which are re-lent to the U.S. parent or to domestic or foreign affiliates. The interest and principal on the bonds issued by the finance subsidiary are guaranteed by the parent corporation. Foreign finance subsidiaries are used to avoid U.S. withholding taxes on the interest paid to the foreign bondholders.

The type of finance subsidiary used will depend, in part, on the intended use of the proceeds. If a corporation seeks money for use abroad, it will sometimes form a special U.S. finance subsidiary—an "80/20 company"—through which it issues bonds. Interest paid by these (U.S.) 80/20 companies to foreign lenders will be treated as foreign source income, and hence will not be subject to withholding (if less than 20 percent of gross income is from U.S. sources). The 80/20 gross income requirement usually is met if the U.S. finance subsidiary invests the borrowed funds in the foreign operations of the corporate group.

The most common practice of borrowers seeking funds for use in the United States is to establish finance subsidiaries in the Netherlands Antilles.[2] This structure is designed to avoid the U.S. withholding tax by claiming the benefits of the tax treaty between the United States and the Netherlands as extended to the Antilles. The subsidiary borrows funds from foreign lenders, and the subsidiary then re-lends the borrowed funds to the parent or to other affiliates within the corporate group.

The finance subsidiary's indebtedness to the foreign bondholders is guaranteed by the U.S. parent (or other affiliates). Alternatively, the subsidiary's indebtedness is secured by notes of the U.S. parent (or other affiliates) issued to the Antilles subsidiary in exchange for the loan proceeds of the bond issue. Under this arrangement, the U.S. parent (or other U.S. affiliate) receives the cash proceeds of the bond issue but pays the interest to the Antilles finance subsidiary rather than directly to the foreign bondholders.

Pursuant to Article VIII of the U.S.-Netherlands Antilles treaty, an exemption is claimed from U.S. withholding tax on the interest payments by the U.S. parent and affiliates to the Antilles finance subsidiary. The interest payments which the Antilles subsidiary in turn pays to the foreign bondholders are not subject to tax by the Antilles. Although most or all of the income of the Antilles finance subsidiary consists of interest payments from its U.S. parent and

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[2] Taxpayers also have pursued the establishment of finance subsidiaries in three U.S. possessions: Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands. The United States does not impose withholding tax on payments of interest, dividends, and other passive income to corporations organized in these possessions. These possessions generally use the Internal Revenue Code as their territorial income tax law by substituting the name of the possession for the words "United States" as appropriate. These "mirror code" rules include the "80/20" source rule that interest and dividends paid by a corporation organized in the possession are not possession -source income if less than 20 percent of the corporation's income is from sources in the possession. A possession subsidiary whose sole activity is lending money to its (nonpossession) U.S. parent, according to some taxpayers, would not earn possession source income. Therefore, taxpayers have contended that payments of interest and dividends from such a corporation to a foreign investor are free of possession withholding tax. (No other finance subsidiary device claims this treatment for dividends.) However, temporary Treasury regulations indicate that income derived from one of these possessions that is not subject to possessions withholding tax is U.S. source income and thus subject to U.S. withholding tax. In addition, a similar result is reached by section 137 of H.R. 4170 (the Tax Reform Act of 1984). Section 137 denies the U.S. tax exemption to residents of the possessions that serve as conduits for foreign investors.

affiliates, that interest income would not ordinarily be treated as effectively connected with a U.S. trade or business of the Antilles subsidiary. Consequently, since less than 50 percent of the gross income of the Antilles finance subsidiary is effectively connected with a U.S. trade or business, no part of the interest paid by the Antilles finance subsidiary to the foreign bondholders would be considered to be from U.S. sources and, accordingly, no U.S. "second-tier" withholding tax would be imposed (sec. 861(a)(1)(C)).[3] Thus, there is no U.S. or Netherlands Antilles withholding tax on the interest paid by the U.S. company to its Antilles finance subsidiary, nor on the interest paid by the finance subsidiary to foreign bondholders. Use of a foreign finance subsidiary may also increase the parent's ability to utilize foreign tax credits, because the subsidiary's net income is foreign source income in the hands of the parent.[4]

Borrowings by U.S. corporations in the Eurobond market occurred originally as a result of a program adopted by the U.S. Government during the 1960s at a time of fixed exchange rates. This program, designed to prevent the devaluation of the dollar, included several measures to encourage U.S. companies to borrow overseas: the Interest Equalization Tax (IET), the Foreign Direct Investment Program, the related Voluntary Foreign Credit Restraint Program, relaxation of the SEC's no-action letter policy with respect to foreign bond issues, and a change in the ruling policy of the IRS which encouraged foreign borrowings through finance subsidiaries. In the case of finance subsidiaries, domestic or foreign, the IRS was prepared to issue private rulings that no U.S. withholding tax applied if the ratio of the subsidiary's debt to its equity did not exceed 5 to 1 and certain other conditions were met. Numerous private rulings were issued on this basis. Finance subsidiaries were also sanctioned by a number of published rulings.[5]

Following the decision by the United States to abandon the fixed exchange rate system and to allow the value of the dollar to be determined by market forces—with the consequent termination of these measures to support the dollar—Eurobond offerings by U.S. corporations decreased. This decrease was in large part due to questions about the exemption from the U.S. withholding tax, which arose when the IRS, citing the expiration of the IET, revoked its prior rulings that properly structured finance subsidiaries would qualify (Rev. Rul. 74-464, 1974-2 C.B.46).

Offerings by a finance subsidiary involve difficult U.S. tax issues, in the absence of a favorable IRS ruling, because finance subsidiaries generally have limited activities, lack significant independent

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[3] Even if the income of the finance subsidiary (the interest it receives from its U.S. parent and affiliates) were treated as effectively connected with a U.S. trade or business, the interest paid by the Antilles finance subsidiary would nevertheless be exempt from U.S. tax under Article XII of the treaty. This situation is advantageous when the taxpayer is in an excess foreign tax credit position because, while subject to U.S. tax on its net income (the spread between the interest it receives and the amounts it pays to the foreign bondholders), the finance subsidiary is not required to make an election to be subject to Netherlands Antilles tax in order to be free of the U.S. withholding tax.

[4] It will be currently includible in the parent's income under the anti-tax haven rules of Subpart F. A "deemed paid" foreign tax credit may be allowed with respect to the Antilles tax on the net income.

[5] Rev. Rul. 73-110, 1973-1 C.B. 454; Rev. Rul. 72-416, 1972-2 C.B. 591; Rev. Rul. 70-645, 1970-2 C.B. 273; Rev. Rul. 69-501, 1969-2 C.B. 233; Rev. Rul. 69-377, 1969-2 C.B. 231.

earning power, and appear to have no substantial business purpose other than the avoidance of U.S. withholding tax. Since the marketing of a Eurobond offering is based upon the reputation and earning power of the parent, and since the foreign investor is ultimately looking to the U.S. parent for payment of principal and interest, the bonds might, in substance, be treated by the IRS as debt of the parent, rather than the subsidiary, and thus withholding could be required.[6] (This risk would appear to increase where, as is sometimes the case, the bonds are convertible into stock of the parent.) Alternatively, the creation of a finance subsidiary might be viewed as having as its principal purpose the avoidance of the withholding tax on the U.S. parent with the result that the exemption might not apply (Code sec. 269).

Nevertheless, these finance subsidiary arrangements do, in form, satisfy the requirements for an exemption from the withholding tax and a number of legal arguments would support the taxation of these arrangements in accordance with their form. Notwithstanding the refusal of the IRS since 1974 to issue rulings with respect to Antilles finance subsidiaries, many bond issues have since been issued on the basis of opinions of counsel.[7]

In recent years, field agents of the IRS have challenged certain arrangements involving Antilles finance subsidiaries.[8] The outcome of these challenges is not yet clear. Typically, the U.S. parent and the finance subsidiary agree to indemnify the foreign bondholder against all U.S. withholding taxes (including interest and penalties) should the IRS successfully attack the claimed exemption from U.S. withholding tax or should U.S. tax law or the tax treaty with the Netherlands Antilles be changed to eliminate the basis for the claimed exemption. Also, the bonds typically provide that if U.S. withholding tax is imposed, the bonds are immediately callable.

Over the last four years, Treasury has attempted to renegotiate the U.S. tax treaty with the Netherlands Antilles. Although past statements would indicate that the new treaty is close to completion, it is not clear when the negotiations will be successfully completed. Similar negotiations with the Brittish Virgin Islands (BVI) concluded unsuccessfully in 1982, and Treasury subsequently terminated the BVI treaty. Treasury has publicly stated that it hopes to negotiate a new treaty that prevents U.S. and foreign investors from abusing the current treaty and bank secrecy laws in the Netherlands Antilles. The government of the Netherlands Antilles has sought to preserve certain treaty shopping benefits enjoyed by nonresident investors. Pointing to the importance of U.S. subsidiar-

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[6] Compare, e.g., *Aiken Industries, Inc.*,, 56 T.C. 925 (1971) and *Plantation Patterns, Inc.* v. *Commissioner*, 462 F.2d 712 (5th Cir. 1972), 72-2 U.S.T.C. Paragraph 9494, *cert. denied*, 406 U.S. 1076, with *Moline Properties*, 319 U.S. 436 (1943), 43-1 U.S.T.C. Paragraph 9464 and *Perry R. Bass*, 50 T.C. 595 (1968).

[7] For detailed discussions of Eurobond financings through finance subsidiaries and of the legal issues presented, see Povell, "International Finance Subsidiaries Under Attack", in Practising Law Institute, Foreign Tax Planning 1983 9 (1983); Lederman, "The Offshore Subsidiary: An Analysis of the Current Benefits and Problems", 51 Journal of Taxation 86 (August 1979), and Chancellor, "Eurobond Financings", U. So. Cal. Tax Inst. 345 (1971).

[8] According to one source, there have been challenges to at least 25 of these arrangements. See 46 Taxes International 13 (August 1983). At lease one company, Texas International Airlines, has disclosed such an audit in a proxy statement. Fialka, "Closing a Loophole," Wall Street Journal, Oct. 11, 1982, at 17, col. 2.

ies as a source of revenue and foreign exchange, representatives of the Netherlands Antilles have urged that the treaty negotiations be viewed in the context of U.S. foreign policy in the Carribean Basin, rather than in the narrow context of tax policy. Thus far Treasury has been reluctant to terminate the Netherlands Antilles treaty because U.S. companies rely on it to borrow from the Eurobond market free of the 30-percent withholding tax.

Table of interest paid and tax withheld

The following table shows portfolio interest paid to foreign recipients and U.S. taxes withheld on that interest income for 1981, based on information returns filed with the Internal Revenue Service. The data are arranged according to the payee's country of address, which is not necessarily his country of residence. This table shows that in 1981, $1.47 billion of interest was paid to recipients in the Netherlands Antilles: this accounted for 28.5 percent of all U.S. source interest paid to foreign investors. Only $5.8 million in U.S. tax was withheld on interest paid to Antilles recipients, which was less than 4 percent of the total withholding tax collected by the Treasury on interest income. It is generally acknowledged that the ultimate recipients of this interest income are rarely residents of the Netherlands Antilles. Most of this interest is routed through the Antilles in order to take advantage of the zero withholding rate provided in the U.S. treaty with the Netherlands Antilles.

Portfolio Interest Paid to Foreign Recipients And U.S. Tax Withheld—1982

[In millions of dollars]

Country	Interest paid				Effective withholding rate (percent)
	Amount paid	Percent of total	Amount withheld	Percent of total	
Bahamas	5.8	0.1	1.4	0.9	24.1
Belgium	38.2	0.7	4.9	3.2	12.8
Bermuda	31.6	0.6	7.5	4.9	23.7
Canada	503.3	9.8	30.4	19.9	6.0
France	265.5	5.1	14.5	9.5	5.5
West Germany	391.5	7.6	6.4	4.2	1.6
Hong Kong	4.1	0.1	0.7	0.5	17.1
Italy	16.9	0.3	1.6	1.0	9.5
Japan	433.3	8.4	32.9	21.6	7.6
Luxembourg	38.2	0.7	0.7	0.5	1.8
Mexico	7.8	0.2	1.2	0.8	15.4
Netherlands	423.3	8.2	1.9	1.2	0.4
Netherlands Antilles	1,470.5	28.5	5.8	3.8	0.4
Panama	36.7	0.7	6.6	4.3	18.0
Saudi Arabia	36.8	0.7	0.1	0.1	0.3
Sweden	8.4	0.2	(1)	(2)	(2)
Switzerland	456.2	8.8	19.8	13.0	4.3
United Arab Emirates	0.7	(2)	(1)	(2)	(2)
United Kingdom	820.2	15.9	2.7	1.8	0.3
Other countries	168.1	3.3	13.5	8.9	8.0
Total	5,157.2	100.0	152.5	100.0	3.0

[1] Less than $50,000.
[2] Less than one-tenth of 1 percent.

Source: Internal Revenue Service, Foreign Returns Analysis Section

III. LEGISLATIVE PROPOSALS

A. Prior Congressional Action

Prior Congresses

In connection with its consideration of the Tax Reform Act of 1976, the House Committee on Ways and Means voted to repeal the 30-percent withholding tax on both interest and dividends. However, the House of Representatives removed this provision from the bill by a vote of 301-119. The Senate Committee on Finance proposed an amendment which would have repealed the 30-percent tax on interest only. However, this amendment was deleted from the bill on the Senate floor by a vote of 54-34.

In 1979, the Senate Committee on Finance reported H.R. 2297, repealing the U. S. withholding tax on portfolio interest paid to foreign lenders, but the Senate did not act on that bill.

In 1980, the House Committee on Ways and Means held hearings on a similar bill, but did not take further action on it.

98th Congress

In September 1983, the Senate Finance Subcommittees on Savings, Pensions and Investment Policy and on Taxation and Debt Management jointly held a hearing on S. 1557[9] (a companion bill to H.R. 3025) that would generally repeal the withholding tax on portfolio interest. The Finance Committee took no action on the bill at that time.

In April 1984, the House passed the Tax Reform Act of 1984 (H.R. 4170) and the Senate approved the Deficit Reduction Act of 1984 (H.R. 2163). Both H.R. 4170 and H.R. 2163 include two provisions which would limit the ability of taxpayers to obtain a U.S. credit for foreign taxes paid by a controlled foreign finance subsidiary. These two provisions would, in some cases, increase the cost of issuing Eurobonds through the Netherlands Antilles. In addition, the Senate amendment includes a provision which would phase out the withholding tax on certain portfolio interest paid to foreign investors by June 30, 1988.

B. H.R. 3025—Messrs. Gibbons, Conable, Et Al.

Withholding tax

Under H.R. 3025 (and a companion bill, S. 1557), interest paid by a U.S. borrower on three categories of debt instruments ("assumed debt," "bearer debt," and "registered debt") would generally be exempt from U.S. tax (under Code sec. 871(a) or 881) if received by a nonresident alien individual or a foreign corporation.

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[9] For a description of S. 1557, see Joint Committee on Taxation staff pamphlet, "Description of Tax Bills (S. 1066, S. 1550, S. 1557, and S. 1666)," JCS-43-83, September 16, 1983.

The first category of exempt interest is interest paid on certain obligations assumed by U.S. corporations after the date of enactment ("assumed debt"). For the interest to be exempt, the U.S. corporation must have assumed an obligation that was issued on or before the date of enactment. When originally issued, the later-assumed obligation must have been guaranteed by a U.S. corporation and must have been sold pursuant to arrangements reasonably designed to ensure that it would be sold (or resold) only to non-U.S. persons. The exemption of interest in this category generally allows U.S. corporations that assume debt of Netherlands Antilles financing subsidiaries to pay tax-exempt interest on that debt. Many contractual arrangements among U.S. borrowers, Netherlands Antilles financing subsidiaries and foreign lenders contemplate assumption by the U.S. borrower in the event of repeal of the 30-percent U.S. tax. The proposal would also generally allow U.S. corporations that assume debt of "80/20" companies to use the proceeds of those borrowings to generate U.S. source income. Interest on assumed debt would be free of U.S. tax even in the hands of foreign persons having direct ownership interest in the U.S. payor, in the hands of a foreign bank, or in the hands of controlled foreign corporations.

The second category of exempt interest is interest on certain obligations not in registered form, i.e., payable to the person who has physical possession of the debt instrument ("bearer debt"). For the interest to be exempt, there must be arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to non-U.S. persons, the interest must be payable only outside the United States and its possessions.[10] This exemption would apply to the debt of any U.S. issuer, not just to debt of U.S. corporations. Therefore, it would apply to obligations of the United States and its agencies.

The third category of exempt interest is interest on an obligation in registered form if the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) has received a statement that the beneficial owner of the obligation is not a U.S. person ("registered debt"). The statement must either (1) represent that it is from the beneficial owner of the obligation or (2) be from a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its business. The statement would not have to identify the owner, but simply to state that the owner was not a U.S. person. The Secretary of the Treasury would have authority to publish a determination to the effect that statements from a securities clearing organization, bank, or other financial institution, or any class of such persons, are not adequate to qualify an obligation for this category. Interest paid more than one month after publication of a notice of inadequacy would be subject to the 30-percent tax, and the agent paying interest in such a case would have a duty to deduct and withhold U.S. tax. This exemption, like the bearer debt exemption, would apply to the debt of any U.S. issuer.

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[10] S. 1557 would also require that on the face of the obligation a statement appear that any U.S. person who holds the obligation will be subject to limitations under U.S. income tax laws pursuant to Code sec. 163(f)(2)(B).

Not all interest on instruments in these three categories would be exempt from U.S. tax. Interest would not be entitled to the exemption from U.S. tax if it were effectively connected with the conduct by the foreign recipient of a trade or business within the United States and thus would be taxed at the regular graduated rates. Also, otherwise exempt interest on bearer debt or registered debt would not be exempt if paid to a foreign person having a direct ownership interest in the U.S. payor. In the case of payments from a domestic corporation, direct ownership exists if the recipient of the interest constructively owns 10 percent or more of the total combined voting power of all classes of stock (entitled to vote) of that corporation. In the case of interest paid by a domestic partnership, direct ownership exists if the recipient of the interest constructively owns 10 percent or more of the capital or profits interest of the partnership.

Foreign banks would not generally be entitled to the exemption for interest they received on an extension of credit pursuant to a loan agreement entered into in the ordinary course of their banking business. The Federal Reserve Board opposes elimination of the withholding tax for interest paid on commercial loans made by foreign banks, since the withholding tax serves to discourage foreign banks from lending into the United States through offshore branches that are not subject to U.S. banking regulations.

Controlled foreign corporations (within the meaning of sec. 957) also would not be entitled to the exemption for interest on bearer debt or registered debt received from U.S. persons. This provision addresses two concerns. First, under current law, dividends paid by a controlled foreign corporation (CFC), attributable to interest earned on U.S. loans, is foreign source income. Thus, CFCs can effectively convert income from U.S. to foreign source.[11] Second, under current law, a CFC may defer U.S. tax on foreign source interest income unless investment income constitutes 10 percent or more of its gross income. Thus a CFC with substantial business income can defer U.S. tax on its interest income. If the CFC lends to a U.S. borrower, interest payments are deducted currently by the borrower, while tax on the interest income is deferred. The 30-percent withholding tax on interest paid to CFCs prevents the revenue loss which might otherwise occur if CFCs invested in U.S. rather than foreign obligations.

Estate tax

The bill would also eliminate any potential U.S. estate tax liability of nonresident alien individuals in the case of obligations; the income from which, if received by the decedent at the time of his death, would be exempt from tax.

Prevention of tax evasion

The bill provides that if the Secretary of the Treasury determines that the United States is not receiving sufficient information from a foreign country to prevent evasion of taxes, then the exemp-

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[11] Section 141 of H.R. 4170 (Tax Reform Act of 1984) and section 128 of H.R. 2163 (Deficit Reduction Act of 1984) would prevent this conversion if more than 10 percent of the CFC's gross income, over a three-year base period, was derived from sources within the United States.

tion would no longer apply to payments addressed to that country or to the accounts of persons within that country for *future* issuances of debt obligations. The termination would not affect existing debt issues and would only continue until the Secretary determines that the exchange of information between the United States and that country is sufficient to identify the beneficial recipients of the interest. Any termination of the exemption for interest will also automatically terminate the exemption from the estate tax on debt obligations.

Under the bill, an explicit duty to deduct and withhold would arise only if the person otherwise subject to the duty knows, or has reason to know, that the income is taxable. The bill would not affect the authority of the Secretary of the Treasury to require a payor to withhold in cases where the payor does not know the identity of the beneficial owner of the securities with respect to which the interest or original issue discount is paid. The present regulations require withholding where the ultimate recipient of the interest is unknown.

Effective date

The amendments providing for the income tax exemption would apply to interest paid after the date of enactment. The amendments providing for an estate tax exclusion for debt obligations would apply to estates of decedents dying after the date of enactment.

C. H.R. 4029—Mr. Barnard

The provisions of the Barnard bill (H.R. 4029) are similar to those in the Gibbons-Conable bill (H.R. 3025); however, the Barnard bill would not extend the exemption from U.S. withholding tax (under Code secs. 871(a) and 881) to interest paid by a U.S. borrower on registered bonds. The staff understands that the intent of the Barnard bill is to prevent existing and future registered debt (both Treasury and private) from competing, on a tax-free basis, with new private bearer bond issues in the Eurobond market. The Barnard bill is also intended to permit the Federal National Mortgage Association (FNMA) to borrow free of withholding tax in the Eurobond market through targeted bearer bond issues. U.S. Treasury obligations are generally issued in registered form and, consequently, would not be eligible for exemption from the 30-percent withholding tax rules under the Barnard bill. However, section 301 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) permits the U.S. government, and agencies thereof, to issue bearer bonds provided that: (1) arrangements are made to ensure that U.S. persons do not purchase these bonds, (2) interest is payable only outside the United States and its possessions, and (3) a statement appears informing potential U.S. holders of the tax consequences of their ownership of such bonds. Thus, U.S. government agencies could borrow funds in the Eurobond market free of withholding, by issuing obligations in bearer form, as provided by the TEFRA.

D. Provisions Contained in the House-passed "Tax Reform Act of 1984" and the Senate-approved "Deficit Reduction Act of 1984"

Recharacterization provisions

Both the House and Senate bills contain two provisions which recharacterize some transactions engaged in by certain U.S.-owned foreign corporations. The first provision (sec. 141 of H.R. 4170 and sec. 128 of H.R. 2163) provides that any distribution or interest payment made by a U.S.-owned foreign corporation to any U.S. person, to the extent attributable to U.S. source income or effectively connected income, will be treated as U.S. source income. However, the provision would not apply if less than 10 percent of the gross income of a U.S.-owned foreign corporation (over a three-year period) is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States. For example, in the case of a Netherlands Antilles finance subsidiary, most of whose gross income is derived from interest on loans made to U.S. affiliates, most of the finance subsidiary's distributions (and subpart F inclusions) would be recharacterized as U.S. source income. The re-sourcing provision would reduce the parent company's foreign tax credit limitation which could decrease the amount of Netherlands Antilles tax credited in that year.

The second recharacterization provision (sec. 142 of H.R. 4170 and sec. 129 of H.R. 2163) treats certain distributions made by a U.S.-owned foreign corporation of earnings attributable to non-business interest income (described in Code sec. 904(d)(2)) as non-business interest for purposes of the foreign tax credit (i.e., the separate limitation for interest income). The interest-connected portion of a distribution is determined as the percentage of earnings and profits attributable to interest in that year. However, the provision would not apply to any distributions made by a foreign corporation during a tax year if less than 10 percent of the foreign corporation's earnings and profits for the three preceeding tax years is attributable to interest income (of the kind to which the provision applies). For example, in the case of a Netherlands Antilles finance subsidiary, most of whose distributions are connected with interest income, this provision would recharacterize distributions (and subpart F inclusions) as interest. This recharacterization provision would subject Netherlands Antilles tax paid by a finance subsidiary (with respect to non-business interest income) to the separate interest limitation. This could reduce the amount of taxes credited in that tax year.

In summary, the effect of the two recharacterization provisions in the House and Senate bills would be to reduce or eliminate the U.S. credit which could be utilized for foreign taxes paid by a U.S.-owned Antilles finance subsidiary. U.S. companies that cannot obtain an interest rate differential in the Eurobond market (relative to the domestic market) large enough to cover the costs of starting and operating a Netherlands Antilles subsidiary, including taxes that cannot be credited, will no longer obtain a net advantage from Eurobond issues. Thus, the effect of the two recharacterization provisions would be to reduce Eurobonds issued through Antilles finance subsidiaries.

Phase-out of 30-percent withholding tax

In addition to the recharacterization provisions, described above, the Senate bill also contains a provision (sec. 142) which phases out the 30-percent withholding tax on certain interest paid to foreign persons. This provision is similar to the Gibbons-Conable bill (H.R. 3025) except that, instead of immediate repeal, the withholding tax on portfolio interest paid to foreign investors is reduced to 5 percent on interest received after the date of enactment, and phased down to 4 percent in 1985, 3 percent in 1986, 2 percent in 1987, 1 percent for the 6-month period January 1-June 30, 1988, and zero after June 30, 1988. The four-year phase-out is primarily intended to give the Netherlands Antilles time to adjust to the decline in U.S. finance subsidiary activity.

IV. ISSUES AND ANALYSIS

A. Comparison of Effects of Legislative Proposals

The Gibbons-Conable and Barnard bills, and certain provisions contained in H.R. 4170 and H.R. 2163, all have the probable effect of reducing the use of Antilles finance subsidiaries. The two recharacterization provisions of the House and Senate bills reach this result by limiting the U.S. credit available for foreign taxes paid by a U.S.-owned Antilles finance subsidiary. The Gibbons-Conable and Barnard bills, and the phase-out provision of the Senate bill, would reduce the utilization of Antilles finance subsidiaries by repealing the 30-percent withholding tax for interest paid on certain obligations issued directly to foreign investors.

If the two recharacterization provisions of the House and Senate bills are adopted without also reducing the 30-percent withholding tax, then U.S. borrowing in the Eurobond market will decline. If the 30-percent withholding tax is repealed without adopting the two recharacterization provisions, then Eurobond issues would increase, but some companies might continue to use Antilles finance subsidiaries to utilize excess foreign tax credits.[12] If both the recharacterization and repeal provisions are adopted, borrowing from the Eurobond market will increase (relative to current law) while the use of Antilles finance subsidiaries will most likely decline.

The phase-out provision of the Senate bill differs from the Gibbons-Conable and Barnard bills in that it is designed to give the Netherlands Antilles economy several years to adjust to the decline in U.S. finance subsidiary activity.

The Barnard bill differs from both the Gibbons-Conable bill and the phase-out provision of the Senate bill, because it is designed to limit the benefits of repeal to nongovernmental borrowers. Absent competition from the Treasury, private borrowers may be able to borrow at only a small premium above the Treasury rate (or even below the U.S. Treasury rate) as under current law.

Under the Gibbons-Conable bill and the phase-out provision of the Senate bill, on the other hand, foreign investors could buy registered U.S. Treasury securities free of withholding tax. As a result, the current interest rate differential between the U.S. and Eurobond markets, on dollar-denominated securities, would likely be reduced or eliminated. The U.S. government borrowing rate would effectively establish an interest rate floor in the Eurobond market, and private borrowers would be unlikely to obtain more favorable interest rates in the Eurobond relative to the domestic market. Thus, both Gibbons-Conable and the phase-out provision of

[12] Treasury may be able to resolve abuses of the Netherlands Antilles treaty and bank secrecy laws in the current treaty negotiations. Alternatively, a more vigorous audit program directed at Antilles finance subsidiaries would tend to discourage their use in the future.

the Senate bill would reduce opportunities to earn "instant arbitrage" profits, by issuing Eurobonds and using the proceeds to buy higher yielding U.S. government securities.

Proponents of Gibbons-Conable assert that if registered securities can be purchased free of withholding tax (as under the Gibbons-Conable bill and the Senate bill but not the Barnard bill), then much of the current underwriting activity in connection with U.S. obligations sold to foreign investors would return to the United States. Some who favor the approach taken in the Barnard bill point out that, with the exception of a few small European countries, most nations do not unilaterally eliminate withholding tax on interest paid abroad. In Britain and France, for example, the exemption from withholding tax on Eurobond issues does not extend to domestic corporate issues purchased by foreign investors.[13]

B. Issues Relating to Repeal of the Withholding Tax

Capital formation

Eurobond issues by U.S. companies increased from $1.1 billion in 1978 to $6.0 billion in 1983. During this period, Eurobond issues rose from approximately 3 to 11 percent of total U.S. corporate dollar denominated bond issues.[14] Eurobond issues peaked at $12.6 billion in 1982, accounting for approximately 22 percent of corporate dollar denominated debt issues in that year. Thus, over the last five years, the Eurobond market has become an important source of medium term (5-10 year) financing for U.S. companies.

The growth in Eurobond issues has been facilitated by the use of Netherlands Antilles subsidiaries which sell bonds, guaranteed by the U.S. parent corporation, to foreign investors free of the U.S. withholding tax. Some argue that repeal of the withholding tax would increase the inflow of capital to U.S. corporations allowing greater domestic investment at lower interest rates.

However, U.S. corporate bonds sold in the Eurobond market comprise only a small portion of the foreign-owned portfolio of U.S. assets. At the end of 1982, U.S. assets held by foreign investors totaled $665.5 billion, including $76.8 billion of corporate equity, $189.2 billion of U.S. government securities, $280.2 billion of deposits in United States banks, and $101.8 billion of direct investments in the United States.[15] Thus, repeal of the withholding tax may cause foreign investors to substitute Eurobonds for other U.S. assets, rather than to increase their net holdings of U.S. assets.

If the primary effect of repeal is to cause foreign investors to shift from short to medium term U.S. securities (resulting in little net capital inflow), then medium term interest rates would tend to decline relative to the short term rate (at least temporarily). This could benefit the U.S. economy by stimulating investment in plant and equipment, and would benefit foreign investors who prefer to hold longer term U.S. government and corporate securities.[16]

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[13] See, *The Economist*, March 3, 1984, pp. 13-14.

[14] Morgan Guaranty Trust Co., *World Financial Markets*, and U.S. Dept. of Commerce, *Survey of Current Business*.

[15] Bureau of Economic Analysis, *Survey of Current Business*, (August 1983) p. 44, table 3.

[16] A similar shift in the relationship between long term and short term interest rates might be achieved by reducing the maturity of treasury debt issues.

Alternatively, the primary effect of repeal could be that some foreigners, who are now investing in dollar denominated bonds issued by non-U.S. borrowers, would switch to U.S. corporate and Treasury securities. This too should reduce medium term interest rates in the United States. However, this net capital inflow would strengthen the dollar and have an adverse impact on the U.S. trade balance (see below).

In either case, repeal of the withholding tax would tend to reduce foreign purchases of stripped Treasury bonds (and other exotic securities) to the extent that foreign investors' demand for these securities is influenced by the withholding tax.

Employment and trade balance

Currently, the United States follows a policy of flexible exchange rates under which the market is allowed to set the value of the dollar relative to other currencies based on supply and demand, rather than having the government attempt to peg the value of the dollar at a particular level. In a regime of flexible exchange rates, net capital inflows strengthen the dollar. A stronger dollar reduces the dollar price of imports into the United States and makes our exports more expensive to foreign purchasers. Thus, a stronger dollar tends to reduce exports and increase imports. Consequently, if repeal of the withholding tax increases net capital flows into the United States, there will be a corresponding reduction in net exports (exports minus imports). On balance, there is likely to be no net increase in employment; instead there is likely to be a shift of employment from export oriented sectors to capital intensive sectors within the United States. A stronger dollar also could aggravate the international debt crisis by making it more difficult for debtor countries to repay their dollar denominated obligations.

These possible adverse impacts of repeal of the withholding tax are likely to be transitory as are positive impacts. As time passes, payments of interest to foreigners will tend to depress the value of the dollar to its pre-repeal level. Likewise, any increase in capital is likely to be transitory. However, given the problems posed by the present high value of the dollar, some argue that even a temporary appreciation of the dollar should be avoided.

Efficiency of world capital markets

The 30-percent withholding tax, like most other taxes, causes some taxpayers to alter their investment and financing decisions. These distortions in behavior may result in a certain amount of economic inefficiency. For example, taxes generally may impede the flow of capital to the most productive investments (i.e., those investments offering the highest pre-tax rate of return). Proponents of repeal of the withholding tax claim that the loss in efficiency is large relative to the revenue raised by the tax. They also point out that the cost of operating Netherland Antilles finance subsidiaries, including taxes paid to the Antilles government, could be avoided. Since the withholding tax raises little revenue and imposes significant efficiency costs on the U.S. economy, proponents argue that it should be repealed. However, many taxes cause an efficiency loss, so the force of this argument depends on the magnitude of the efficiency cost per dollar of tax collected *relative* to other U.S. taxes.

International tax avoidance and evasion

If tax is not withheld on interest paid to foreign investors, and U.S. borrowers issue foreign bonds in bearer form, then the interest income may not be taxed in any country. In this case, the borrower deducts interest paid abroad, reducing domestic tax liability, with no offsetting increase in the tax base of any jurisdiction. Ultimately, such unrestricted cross-border lending could cause substantial tax base erosion in both the borrowing and lending countries. Also, as a result of enforcement difficulties, some of these tax-free bonds might be held by U.S. persons evading U.S. tax. Consequently, repeal of withholding could undercut the long term efforts of the United States to curb international tax evasion, and discourage other countries from assisting in that effort.

Those favoring repeal respond that there are virtually unlimited opportunities for taxpayers to evade taxes if they so intend, and that repeal of the U.S. withholding tax is unlikely to increase tax evasion and avoidance. Moreover, they oppose measures to reduce tax evasion opportunities, such as a registration requirement on Eurobond issues, on the grounds that there would be little foreign demand for U.S. bonds under these circumstances.

Equity arguments

Opponents of repeal argue that it would be inequitable to exempt foreign lenders from tax on U.S. source interest income while continuing to tax interest received by U.S. lenders. In their view, foreign lenders enjoy the income and security from investing in the United States and thus should not be exempt from paying U.S. tax on the income received, particularly since the U.S. borrowers reduce their U.S. tax by deducting the interest payments.

Proponents of repeal counter that the correct comparison is not with the U.S. treatment of U.S. lenders but with the way in which other foreign countries treat lenders from outside their borders since these rules determine the environment in which U.S. borrowers must compete for funds. Proponents point out that certain other countries provide mechanisms for the issuance of Eurobonds free of withholding tax. Proponents also claim that the equity argument is superficial because, in their view, foreign lenders will not pay U.S. tax on U.S. source interest income even if the United States continues to impose it; they will instead invest elsewhere.

Treaty negotiations

Opponents argue that repeal of the withholding tax would result in the unilateral surrender of a valuable "bargaining chip" available to our tax treaty negotiators. Foreign countries have less of an incentive to reduce their withholding taxes on interest paid to U.S. investors if the corresponding U.S. withholding rate is zero by statute. In 1982, 19.9 percent of U.S. withholding tax collections were attributable to interest paid to Canada, a country that has been reluctant to negotiate a reciprocal reduction of withholding rates on interest. Moreover, an additional 34.6 percent of the withholding tax revenue was from Switzerland and Japan, countries that have refused to negotiate reciprocal reductions in withholding tax rates to zero. Thus, more than half of the revenue loss resulting from

unilateral repeal would merely be a transfer to the Treasuries of those countries (or a windfall for investors resident in those countries).

On the other hand, those favoring repeal argue that reliance on reciprocal rate reductions or exemptions in tax treaties is arbitrarily discriminatory in the area of portfolio investment. Even if the withholding tax were repealed, other countries would still have an incentive to enter into treaties with the United States to reduce double taxation of income other than portfolio interest, and to eliminate fiscal evasion. This is particularly true if repeal is targeted so that it does not generally apply to interest paid to related parties or banks. In addition, many foreign countries might prefer not to encourage their investors to export capital to the United States. Finally, in the case of at least one treaty negotiation, i.e., with the Netherlands Antilles, repeal of the withholding tax would clearly strengthen Treasury's negotiating position.

Treaty shopping

Proponents of repeal argue that present law has a much more deleterious effect on the tax treaty program than the loss of any possible advantages that the withholding tax may have as a bargaining chip. In order to attract needed foreign investment, they argue, the United States tolerates treaty arrangements that permit U.S. corporations to issue tax free Eurobonds through finance subsidiaries in the Netherlands Antilles. The Netherlands Antilles treaty has been referred to as "a one-way treaty with the world" because of the U.S. tax benefits which flow through to third-country investors. If the United States approves the use of treaties by third-country residents, it may encourage other treaty shopping abuses of our tax treaty network.

Proponents of repeal argue that repeal would allow the United States to take a much more aggressive position in renegotiating the treaty with the Netherlands Antilles. They argue that the main benefit the United States derives from the treaty is access to the Eurobond market. If the withholding tax is repealed, the United States would have much less reason to concede matters of substance to the Antilles in these negotiations. Specifically, the United States will have little or no reason to agree to the treaty shopping arrangements the Antilles seek for Antilles corporations beneficially owned by third country residents.

Opponents respond that the treaty shopping abuses of the Netherland Antilles and other treaties can be eliminated by renegotiating these treaties. They argue that repeal of the tax would not be a sensible solution to tax avoidance.

Withholding tax as a protective tariff

Proponents of repeal of the 30-percent withholding tax argue that the attractiveness of U.S. bonds in the international bond market is greatly diminished by the withholding tax, so that the tax is a barrier to international trade in assets. The marketability of U.S. bonds abroad is limited to the extent that foreign bondholders, in non-treaty countries, are unable to claim credit for the U.S. withholding tax. This is the case for foreign tax exempt entities such as foreign pension funds and bondholders in an excess credit

position. Also many foreign investors are reluctant to claim the credit because anonymity of ownership is sacrificed.

Opponents of repeal assert that the United States grants foreign jurisdictions the same right to tax interest income at its source and allows a credit for withholding taxes paid by domestic lenders. Furthermore, the United States Treasury position has been to bilaterally reduce or eliminate the withholding tax in treaty negotiations. Opponents view the tax as comparable to, and in lieu of, the income tax imposed on U.S. lenders. The tax is not designed to discourage foreign persons from buying U.S. government and corporate bonds but merely to subject them to a tax comparable to the tax paid by U.S. bondholders. They believe it would be inappropriate to eliminate the tax merely because it reduces the marketability of domestic bonds to foreign investors seeking to avoid taxation in their home countries.

Revenue-maximizing rate of the withholding tax

Some opponents of repeal make the point that a lower-rate withholding tax might raise substantially more revenue than the current 30-percent tax. They argue that above a certain tax rate (less than 30 percent) collections from the withholding tax fall off because of the greater incentive for tax avoidance. This analysis suggests that the withholding tax rate should be lowered to the point at which revenue collections of the Treasury are maximized (i.e., the tax rate should be set equal to the marginal cost of withholding tax avoidance). Such a revenue-maximizing tax might be in the range of 1 to 5 percent and probably would have to be accompanied by the closing of the Netherland Antilles "window."[17]

Foreign policy aspects

Netherlands Antilles finance subsidiaries are the principal method for avoiding U.S. withholding tax on corporate obligations sold to foreign investors. This results in considerable financial activity in the Antilles. The Antilles government has argued against repeal of the general withholding requirement in the U.S. Code because the use of the Antilles as a financial center would be substantially reduced. Antilles tax on foreign financing activities purportedly generates about 30 percent of the Antilles budget. The 4-year phase-out of the the withholding tax, as provided in the Senate bill, is designed to cushion the impact of repeal on the Antilles economy. However, representatives of the Antilles have asserted that the phase-out, like outright repeal of the withholding tax, would severely damage the economic health of the islands.

However, proponents of repeal point out that the need to route transactions through the Antilles adds needlessly to the cost of borrowing. The same business that now generates jobs in the Antilles could be used to generate more employment in the United States. Due to the availability of the foreign tax credit, some of the revenues collected by the Antilles may in effect already come out of the

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[17] The recharacterization provisions in H.R. 4170 (secs. 141-142) and H.R. 2163 (secs. 128-129) could significantly reduce the use of Antilles finance subsidiaries by limiting the U.S. credit available for taxes paid to the Netherlands Antilles. The use of conduit entities might also be eliminated by renegotiating the Antilles treaty.

U.S. Treasury through reduction of the U.S. tax burden on the U.S. parent of an Antilles finance subsidiary. Further, proponents of repeal argue that it is illogical from a foreign policy standpoint for the U.S. contribution to a Caribbean country's economy to be determined by that year's interest payments on Eurobonds. Some argue that to insure the stability of the Antilles, the United States should replace a portion of the Antilles tax revenue, lost as a result of repeal of withholding, with a program of direct foreign aid.

Disclosure requirements

In its consideration of similar legislation in the 96th Congress, the Senate Finance Committee report made it clear that it intended that information reporting requirements remain in effect with respect to interest exempt from withholding tax. In addition, the Committee report indicated the intention that the Treasury use its authority to require withholding where the payor of the income does not know the owner of the securities on which the interest is paid. The Committee report made it clear that this authority was to be used to ensure the collection of tax where interest is paid to related parties.

Those who oppose an interest reporting requirement contend that it does not comport with the realities of the Eurobond marketplace and therefore would nullify any beneficial effect of the repeal of withholding. They point out that the Eurobonds issued by competing borrowers from other countries do not require withholding, are free of reporting requirements, and are typically in bearer, rather than registered, form. A requirement that the lender report his identity to qualify for exemption from withholding would impose an administrative burden on lenders and could also raise some doubt in the minds of the lenders as to whether the obligations in their hands qualified for exemption from withholding. Those arguing that there should be no disclosure requirements for obligations that generally yield tax-free income argue that the loss of anonymity would make it impossible, as a practical matter, to market the obligations of U.S. borrowers to those foreign investors who are unwilling to have their identities disclosed to the IRS. They argue that the U.S. Treasury would have less difficulty in preventing evasion of U.S. tax by U.S. taxpayers if U.S. borrowers could issue debt directly, rather than through the Netherlands Antilles. They contend that strict Antilles bank secrecy laws now make it difficult to determine the ultimate beneficial owner of debt issued by financing subsidiaries.

Those who support the information reporting requirements argue that, without these rules, it would be simple for related parties to avoid the limitations on the exemption from withholding. It would be possible, although difficult, to track down interest income paid to foreign subsidiaries through the Internal Revenue Service audit process. Many U.S. shareholders of controlled foreign corporations (CFCs) would never be audited. It would generally not be possible to audit foreign direct investors. Additionally, those supporting reporting requirements argue that their absence would assist U.S persons to evade U.S. tax by investing anonymously in bearer obligations abroad. They argue further that the principal reason foreign holders of bearer bonds would refuse to disclose their identi-

ties to the IRS is that they are evading taxes and currency control requirements of their own countries. They argue further that a decision by the United States not to require the reporting of the identity of the beneficial owner in order to increase the marketability of bonds issued by U.S. companies would be contrary to the U.S. policy not to condone foreign fiscal fraud and contrary to the spirit of our tax treaty exchange of information obligations.

Foreign tax credit

To the extent that foreign investors in U.S. Eurobond issues are exempt from U.S. withholding by treaty, or claim a tax credit for withholding taxes paid to the United States, repeal of the U.S. withholding tax will not increase foreign demand for U.S. debt issues. Where foreign investors credit U.S. withholding taxes against home country tax, repeal simply transfers revenue from the U.S. to foreign treasuries.

On the other hand, repeal of withholding generally would result in a windfall for investors resident in low-tax countries, and for pension trusts in developed countries that cannot fully credit U.S. withholding tax (as a result of tax exempt status).

Foreign banks

Federal Reserve regulations require a 3-percent reserve on both nonpersonal time deposits and Eurodollars which are used to support lending by U.S. offices of both foreign banks and domestic depository institutions. Loans to U.S. residents from foreign offices of U.S. depository institutions are also subject to a 3-percent reserve requirement.

The Federal Reserve Board established a 3-percent reserve requirement in order to reduce the incentive to lend from abroad as a means of avoiding domestic reserve requirements. The Board was concerned that in the absence of such a requirement, capital flows could increase in both directions: U.S. residents would have an incentive to make deposits in the Eurodollar market, and these funds would in turn be used by banks to make loans to U.S. residents. The Board has noted that the volume of such "round-trip" flows has rapidly increased.

However, the 3-percent reserve requirement is not applicable to loans to U.S. residents from foreign offices of foreign banks. The withholding tax on interest paid to foreign investors in present law serves, in part, to reduce the incentive for foreign domiciled banks to shift abroad their lending to U.S. residents in order to avoid U.S. reserve requirements. The position of the Federal Reserve Board has been to oppose repeal of the 30-percent withholding tax on interest paid to banks domiciled abroad, pursuant to a loan agreement entered into in the normal course of their banking business, in order to deter such banks from avoiding U.S. reserve requirements by making loans to U.S. residents from offshore offices.

Foreign subsidiaries (controlled foreign corporations)

None of the repeal bills provides an exemption for interest paid to controlled foreign corporations (CFCs)[18] on the grounds that there are a number of ways in which such an exemption could result in undue tax advantages. However, the bills do exempt CFCs from U.S. tax on assumed debt—debt assumed by U.S. corporations.

If CFCs could receive interest income free of withholding tax, U.S. tax on that income could be deferred indefinitely, if the CFC also had an active business. Alternatively, if the U.S. parent had excess foreign tax credits from unrelated foreign business operations, the interest could in effect be repatriated to the parent tax-free. Finally, even if neither of these fact patterns applies and the interest income of the foreign subsidiary is currently taxable to the U.S. parent under subpart F, without being fully offset by foreign tax credits, the U.S. parent could benefit by being able to invest pre-tax dollars in U.S. debt obligations rather than only the amount remaining after imposition of U.S. tax. Each of these possibilities is explained in greater detail below.

In the case of a controlled foreign corporation (CFC), subpart F (Code secs. 951-64) provides that, in general, the United States shareholders must currently include in their income certain types of tax haven income of the corporation and certain types of passive investment income, including interest income. However, no inclusion is required if these types of income amount to less than 10 percent of the gross income of the corporation. Most corporations with active businesses abroad are eligible for this exception because the *gross* income from their business activity is generally more than 90 percent of total gross income even though their net investment income may be a larger proportion of their overall net income because of greater expenses associated with the active conduct of a business.

Advantages could exist for the U.S. shareholder of a CFC even if the shareholder were required to report the interest income currently. For example, suppose that a U.S. parent company has excess foreign tax credits.[19] If the U.S. parent lent money directly to a U.S. borrower, the U.S. parent would, of course, be taxable on the interest income. However, if the U.S. parent makes an investment (such as buying assumed debt) through a foreign subsidiary (a CFC), the U.S. parent may, in effect, receive the income tax-free. The U.S. source interest income could (absent U.S. withholding) be

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[18] Generally, a foreign corporation is a CFC if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom holds 10 percent or more of the voting power.

[19] The United States taxes domestic taxpayers on their worldwide income, but allows a credit against its tax for foreign income taxes. The credit allowable in any year is limited, however, by a formula which is generally intended to allow the foreign tax credit to offset only the U.S. tax on the taxpayer's foreign source income, not the tax on its U.S. source income. Generally, the limitation is equal to the taxpayer's pre-credit U.S. tax multiplied by a fraction, the numerator of which is the taxpayer's foreign source taxable income and the denominator of which is the taxpayer's worldwide taxable income. A taxpayer whose foreign income taxes are greater than this limit is said to have excess tax credits. The excess credits may be carried back 2 years and forward 5 years to be utilized in years in which the taxpayer's foreign tax credit limitation formula exceeds foreign income taxes actually paid. However, if the excess credits cannot be used in any of these years, they are lost forever. Many taxpayers find that, because of high foreign tax rates, they are chronically in an excess credit position.

received by the subsidiary free of U.S. tax. The only tax paid by the subsidiary would be the tax imposed by the country in which it is received, which may be considerably lower than the U.S. tax rate paid by the parent.[20] When this interest income of the subsidiary is taxed to the U.S. shareholder under subpart F or as an actual dividend, the dividend may be treated as foreign source income, because the CFC is a foreign corporation, even though the interest income received by the CFC was from U.S. sources. Thus, U.S. source income (the interest) may in effect be converted into foreign source income (the dividend). This increases the U.S. shareholder's foreign tax credit limitation and may permit the taxpayer to use its excess foreign tax credits from its unrelated foreign active business operations (which might otherwise expire unused) to offset completely its U.S. tax on the income, allowing the U.S. interest income to be received without imposition of any U.S. tax.

A U.S. shareholder of the CFC may obtain tax advantages from repeal of the withholding tax even if the shareholder is not in an excess foreign tax credit position. If the CFC has accumulated earnings abroad which are not subpart F income, it could not repatriate them without causing its U.S. shareholder to pay U.S. tax on the dividend income. [21] The U.S. shareholder could then reinvest only the after-tax amount of the dividend in obligations of U.S. companies. However, if the income is not repatriated, the CFC could invest the pre-tax amount of earnings (which, if foreign income taxes are low, could be considerably larger than the amount which would remain after U.S. tax) in obligations of U.S. companies. Thus, although the U.S. parent would be subject to to current U.S. tax on the interest income earned by the foreign subsidiary under subpart F (unless the 10-percent de minimis rule described earlier applied), the subsidiary would have had a larger amount available to invest, and thus would receive more income, than the U.S. parent would have had if the funds had been repatriated to it as a dividend. This could be attractive if the subsidiary were not also burdened with a withholding tax on interest received. While this would be attractive even where the higher amounts of interest income of the CFC are currently taxable to the U.S. parent under subpart F, it is particularly attractive where, on account of the 10-percent de minimis rule, the interest is not subpart F income taxable to the U.S. parent.

Those who favor extending the repeal of the withholding tax to all interest paid to CFCs point out in this last situation that discouraging the CFC from investing in debt of U.S. obligors is contrary to the policy expressed by Congress in the Tax Reform Act of 1976. Prior to the amendments made by that Act, U.S. shareholders of CFCs were treated as receiving a dividend from the CFC whenever the CFC invested in the "U.S. property," including debt obligations of U.S. persons. This rule was adopted because it was felt

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[20] If the tax paid on the interest to the foreign country in which it is received is at least equal to the U.S. rate of tax, then the parent would have no incentive based on this analysis to structure the loan through the foreign subsidiary. However, if it did so, the parent would still pay no U.S. tax, so that net result would be a transfer of funds from the U.S. Treasury to the foreign country's treasury.

[21] This assumes that the U.S. shareholder would not be entitled to an indirect foreign tax credit (for taxes paid by the CFC on its income) which would eliminate U.S. tax on the dividend.

that reinvestment of the funds in the U.S. was a repatriation essentially equivalent to a dividend. However, the 1976 Act changed this rule to permit portfolio investment in the United States without imposition of current tax under subpart F. Thus, CFCs were no longer encouraged by subpart F to reinvest earnings abroad, rather than in the United States. It was believed that this would improve the U.S. balance of payments in encouraging capital inflow from CFCs into the United States. Proponents also point out that, if a U.S. withholding tax is imposed on interest received by a CFC, and the U.S. tax on dividends from the CFC is not eliminated by the foreign tax credit, double taxation of the income will result. That is, the income will be taxed once by the United States when paid to the CFC and will be taxed a second time when paid as a dividend by the CFC to the U.S. shareholder. Proponents of the bill's approach argue that it leaves CFCs where they are under current law, because CFCs can now invest in obligations of Netherlands Antilles finance subsidiaries of U.S. corporations without incurring the U.S. withholding tax.

V. REVENUE EFFECT

Direct Revenue Effect

In 1982, the most recent year for which data is available, $152 million of tax was withheld on interest paid to foreign investors. Approximately two-thirds of the tax withheld was attributable to interest paid to investors in Canada (15-percent withholding rate), France and Japan (10-percent withholding rate), and Switzerland (5-percent withholding rate). Investors in these countries are generally able to reduce their home-country tax liability by the full amount of tax withheld in the United States.

Under the Gibbons-Conable bill and the phase-out provision in Senate amendment (Deficit Reduction Act of 1984), the statutory rate of withholding on portfolio interest paid to foreign investors would generally be reduced to zero. Thus, the direct revenue effect of Gibbons-Conable and the Senate phase-out would be the loss of all withholding tax receipts (except withholding on interest paid to controlled foreign corporations, 10-percent shareholders, and foreign banks).

The loss in withholding tax would likely be smaller under the Barnard bill, since the statutory withholding tax rate is reduced to zero only on special bearer bond issues designed for the foreign market.

Indirect Revenue Effect

Under current law, U.S. corporations borrow in the Eurobond market, free of withholding tax, through finance subsidiaries established in the Netherlands Antilles. These subsidiaries are subject to Netherlands Antilles tax, and a U.S. tax credit is claimed for taxes paid in the Antilles. Thus, under current law, U.S. revenue is reduced by the amount of tax U.S. finance subsidiaries pay to the Netherland Antilles. According to IRS Statistics of Income data for tax year 1980, U.S. subsidiaries paid approximately $41 million of tax to the Netherlands Antilles. To the extent that repeal of the withholding tax reduces the use of Antilles finance subsidiaries, and thus the U.S. credit for Antilles tax, there is an indirect revenue gain.

Both the Gibbons-Conable and Barnard bills are likely to reduce new bond issues through Netherland Antilles finance subsidiaries. Also, as provided by these bills, Antilles bonds assumed by a parent corporation would be free of withholding tax. Thus, some outstanding Antilles bonds would likely be assumed to avoid potential audit risk. There would be a revenue gain under both bills to the extent creditable taxes paid to the Antilles are reduced.

It is not clear, however, that it is appropriate to attribute any indirect revenue increase to this legislation, because it is not clear

that the bill would cause taxpayers to claim less foreign tax credits than they otherwise would be entitled to. First, it is not clear that Eurobond issues by U.S. companies would continue in the future (absent legislation). The progress of audits of Netherlands Antilles finance subsidiary arrangements in the ordinary course of administrative practice could cause future offerings to decrease or even to stop. Similarly, if Treasury ruled that it would not in the future treat new Eurobond issues as qualifying under the treaty, it is doubtful that any new offerings would occur. In either event, the bill could cause a revenue loss. Second, it is not clear to what extent the taxes that the Netherlands Antilles imposes on finance subsidiaries are income taxes that are properly creditable rather than taxes on capital. If these taxes are not creditable, the bill would not reduce proper claims of foreign tax credits.

Other Revenue Considerations

Repeal of the withholding tax would have potential revenue consequences which are more difficult to quantify than the change in withholding tax and foreign tax credits. To the extent that repeal of the withholding tax causes U.S. taxpayers to borrow from foreign rather than U.S. lenders there would be a revenue loss, because foreign lenders would pay no U.S. tax (as a result of repeal). Frequently, foreign lenders also evade home-country taxes on Eurobonds due to the absence of reporting requirements. Thus, in many cases, Eurobond issues are effectively tax-free bonds. To the extent that repeal of the withholding tax increases the amount of effectively tax-free international debt, there is likely to be a revenue reduction in the U.S. and abroad.

Proponents of repealing the withholding tax assert that repeal will result in a net capital inflow which will generate additional income and tax liability in the United States. However, there may be offsetting factors. First, exports (and export income) are likely to decline to the extent that net capital inflows strengthen the dollar. Second, debt-financed investment is unlikely to generate significant U.S. tax revenue in view of the interest and accelerated depreciation deductions and the investment credit under current law.

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(correction to table heading)

Portfolio Interest Paid to Foreign Recipients And U.S. Tax Withheld—1982

[In millions of dollars]

Country	Interest paid		U.S. tax withheld		Effective withholding rate (percent)
	Amount paid	Percent of total	Amount withheld	Percent of total	
Bahamas	5.8	0.1	1.4	0.9	24.1
Belgium	38.2	0.7	4.9	3.2	12.8
Bermuda	31.6	0.6	7.5	4.9	23.7
Canada	503.3	9.8	30.4	19.9	6.0
France	265.5	5.1	14.5	9.5	5.5
West Germany	391.5	7.6	6.4	4.2	1.6
Hong Kong	4.1	0.1	0.7	0.5	17.1
Italy	16.9	0.3	1.6	1.0	9.5
Japan	433.3	8.4	32.9	21.6	7.6
Luxembourg	38.2	0.7	0.7	0.5	1.8
Mexico	7.8	0.2	1.2	0.8	15.4
Netherlands	423.3	8.2	1.9	1.2	0.4
Netherlands Antilles	1,470.5	28.5	5.8	3.8	0.4
Panama	36.7	0.7	6.6	4.3	18.0
Saudi Arabia	36.8	0.7	0.1	0.1	0.3
Sweden	8.4	0.2	(1)	(2)	(2)
Switzerland	456.2	8.8	19.8	13.0	4.3
United Arab Emirates	0.7	(2)	(1)	(2)	(2)
United Kingdom	820.2	15.9	2.7	1.8	0.3
Other countries	168.1	3.3	13.5	8.9	8.0
Total	5,157.2	100.0	152.5	100.0	3.0

[1] Less than $50,000.
[2] Less than one-tenth of 1 percent.

Source: Internal Revenue Service, Foreign Returns Analysis Section

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